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CMBS MARKET IS TRANSFORMED BY INFO AND INDEXES

Contents

Lehman Brothers' inclusion of commercial mortgage-backed securities in its aggregate bond index starting this Thursday is the latest, and some sources say the most significant, in a wave of changes that are revolutionizing the CMBS market.

With the addition of CMBS to the index, many index funds and pension funds will have the incentive to purchase commercial mortgage securities for the first time. In addition, a buy side that has lived on a scarce diet of data now finds itself contending with a surfeit of new CMBS indexes and information from Wall Street firms. Further, such shops as Lehman and Goldman, Sachs & Co., among others, stand to benefit from the higher profile that the market is attaining by offering options like swap programs and model portfolios to newcomers who want the returns of CMBS without managing the risk.

These changes amount to an information revolution in a market in which some players used to draw historical pricing information from specialized newsletters. Things began to change a little more than six months ago when both Lehman and Banc of America Securities rolled out CMBS indexes designed to give investors a method of benchmarking securities. Now Merrill Lynch & Co. may also begin offering expanded information on CMBS deals, sources said.

But Lehman's inclusion of CMBS in its major bond aggregate index, one of the most widely used indexes in the fixed-income market, dwarfs all of those actions, several investors said. Having CMBS making up a portion of a leading bond index gives the business credibility and continuity, one buy-side head said. "It's hard to say that one is better than the other, but the Lehman aggregate is the single most followed from an index management standpoint," he said.

"I think it's a good move for the commercial mortgage market, as [the addition to the Lehman index] really cements it as a permanent sector within fixed income," added Michael Hoeh, senior portfolio manager at Dreyfus Corp. "CMBS is no longer going to be an off-the-run product."

The CMBS presence in Lehman's aggregate bond index will be selective, including only the ERISA-eligible top-rated CMBS, or about $65 billion in securities. While the bonds represent about 1.2% of the total index at present, buy-side sources said they believe issuance growth and longer bond maturities will cause CMBS to become a much greater component of the index, perhaps gaining territory now occupied by such sectors as corporate bonds.

Steve Berkley, a Lehman managing director who runs its index operations, said that the CMBS portion of the index would likely expand in the next few years, adding that if the potential for steady

growth had not been there in the asset class, Lehman would not have included it in the first place.

With the infusion of CMBS into the Lehman aggregate index, the market could experience a variety of changes. Deal sizes may rise to meet the requirements demanded by the index, price tiering may occur, and spreads may tighten, sources said.

As CMBS become a greater fixture of the bond index, investors expect competition to increase, predicting at least an 0.10% tightening in spreads when the new index begins, and possibly more to come in the future. One speculation shared by several investors is that Lehman index-eligible bonds will eventually be priced distinctly from bonds that don't make the cut due to either size or collateral, thus creating a level of price tiering where there is little or none at present.

"Maybe this will create more of a premium for larger transactions," Hoeh said.

Rags to Riches

The CMBS market has always run on a different fuel than its mortgage-backed and asset-backed siblings. Deals require much more work to assemble and come at erratic paces. Its early deal history is sketchy, prompting Lehman to use a late-1996 cutoff point for assembling back history for its index. And its top players are not officially crowned, as Thomson Financial Securities Data does not run separate commercial mortgage-backed securities underwriter rankings, instead incorporating such deals into its general MBS rankings.

The relative lack of information on deals and pricing proved amenable to the mid-1990s, when the market was in the $15 billion to $20 billion range. But with last year's issuance total of roughly $57 billion, combined with the increased exposure the market was receiving, the old ways of pricing and grading deals were becoming increasingly obsolete.

It was a fertile climate for new indexes. Morgan Stanley Dean Witter had offered a CMBS index for two years, but buy-side sources said it was not widely used for comparative purposes. When then-NationsBanc Montgomery Securities and Lehman Brothers debuted their indexes early this year, the market finally had something resembling the variety of benchmarks used by other fixed-income players.

Lehman's index differs from Banc of America in its size requirements. The Lehman CMBS index requires that a deal price at a minimum of $500 million and currently have a minimum remaining balance of $300 million, where Banc of America opens its index to all varieties of deals. Banc of America's head of mortgage research, Michael Youngblood, argues that its broader policy paints a more accurate picture of the breadth and current state of the CMBS market.

But Berkley said the size and other restrictions (floating-rate and agency securities also do not make the cut) are designed to weed out smaller, illiquid deals that investors would have a hard time buying in the first place. "If you had everything in there, you'd end up with a lot of noise in the index," Berkley said. "We want to make sure the index is invest-able."

Stricter guidelines are becoming more common throughout Lehman's index family, with recent changes to the bond aggregate index raising the minimum size for deals to $150 million from $100 million.

While Lehman argues that this is designed to better reflect current market conditions and better match investor goals, some market observers note that the changes may benefit sectors that favor large deals, such as telecom, over those that have smaller-sized offerings, like power and utility providers.

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By Christopher O"Leary

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Abstract: Focuses on the calls by portfolio managers for investor companies on Wall Street to create a commercial mortgage-backed securities (CMBS) index. Benefits of a CMBS to investors; Comments from Michael Hoeh, senior manager at The Dreyfus Corp.; Views of the Morgan Stanley company on the CMBS index.

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TOTAL RETURN MANAGERS CALL FOR CMBS INDEX

With the commercial mortgage-backed securities market on track to double last year's $40 billion of issuance, portfolio managers are imploring Street firms like Lehman Brothers to create a new CMBS index.

The demand for an index has intensified lately as more total return investors have entered the burgeoning CMBS market, sources said.

While all investors would stand to benefit from an index, it's especially important to total return buyers since they often judge their performance against one.

"I think it would be useful for a lot of investors like ourselves who use CMBS deals in a broad investment-grade portfolio," said Michael Hoeh, senior

portfolio manager at The Dreyfus Corp. While sources say there are a handful of firms working on such an index, the only one that has stated publicly it would do so is Lehman. No specific rollout date has been set, but Lehman officials are hopeful the product will be introduced before year-end.

"A number of money management firms who are looking for a benchmark have asked us to do this," said Steve Berkley, managing director and head of index products at the firm.

It's interesting to note that Morgan Stanley Dean Witter already has a CMBS index that has been in place for two years now.

However, market players say the index isn't a widely used benchmark, in part because Morgan Stanley isn't known as a major provider of bond indices.

Hoeh explained that while Morgan Stanley's index can be useful in judging the absolute performance of the sector, it can't really be viewed in the context of a broader bond index. "Morgan Stanley doesn't have a commonly quoted index," he added.

Defending Morgan's index

For its part, Morgan Stanley points out that its CMBS product doesn't limit its analysis to investment-grade securities, incorporating the junk-rated subordinate pieces into the equation as well.

"We try to mimic the entire CMBS universe," said Howard Esaki, principal at the firm. (Lehman has made no determination yet as to whether it will include both investment-grade and noninvestment-grade bonds, Berkley said.)

The hope is that a new product would help to eliminate the confusion money managers often encounter when measuring a commercial mortgage bond's value, a problem that becomes more important to address as the market expands.

"The hard part for many money managers is to figure out where [CMBS] fit," said a CMBS analyst. "Is it a trade versus mortgages, or a trade versus corporates?"

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Document View

Rating of residential mortgage-backed securities

Jones, Andrew B, Hayssen, Henry W, Schneider, Jennifer E. **The Journal of Fixed Income**. New York: Mar 1995. Vol. 4, Iss. 4; pg. 12, 25 pgs

Abstract (Summary)

The criteria of Duff & Phelps Credit Rating Co. (D&P) for rating residential **mortgage-backed securities** (MBS) is reviewed. From a quantitative perspective, D&P analyzes the riskiness of each **mortgage** underlying the MBS and determines the amount of protection required for a specific rating. Qualitatively, D&P evaluates the originator and servicer and analyzes the structure to determine that distributions of principal and interest are made to MBS investors as set forth in the transaction documentation. The updated D&P approach to rating MBS is a state-of-the-art analysis of the many characteristics affecting the credit quality of MBS. It provides investors with an expanded analytical review, incorporating new sources of information and using existing industry data in a more systematic manner. In developing its approach, D&P has constructed a housing price **index**, combining innovative as well as conventional housing price and other economic data.

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Constant-duration mortgage index

Lev Dynkin, Jay Hyman, Vadim Konstantinovsky, Ravi Mattu. **The Journal of Fixed Income**. New York: Jun 2000. Vol. 10, Iss. 1; pg. 79

Abstract (Summary)

This paper introduces a mortgage-backed securities index dynamically rebalanced to a desired duration target. It can serve as a performance benchmark for MBS portfolios that are delta-hedged against fixed liabilities or duration targets. It can also be used to compare returns on mortgages to returns on Treasuries with the same duration. Performance results show that the return advantage in a stable yield environment more than compensates for the adverse effect of negative convexity in trending and volatile periods. Historical simulation over 1994-1998 shows that the dynamic MBS strategy targeting the duration of the Lehman Brothers Treasury Index retains most of the mortgage-backed securities' return advantage, with a tracking error comparable to the historical volatility of excess return for other spread products.

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